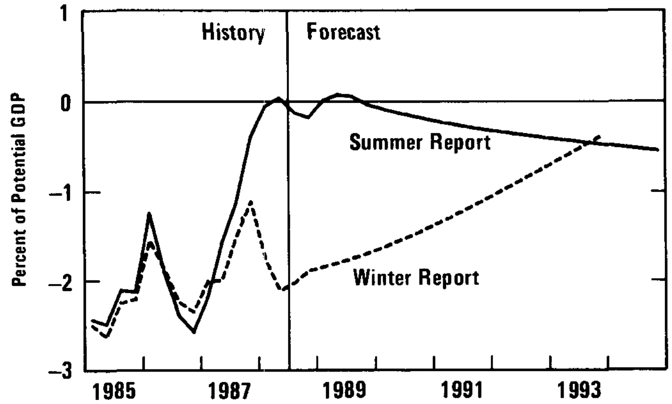
Figure I-16.

Shortfall of Gross Domestic Product Below Potential



SOURCE: Congressional Budget Office.

NOTE: The gross domestic product gap is the difference between actual and potential real gross domestic product. The Congressional Budget Office's method of calculating potential GDP is detailed in Appendix B of *The Economic and Budget Outlook: An Update* (August 1987).

Annual debt service therefore rises by $49 billion between 1987 and 1994. Thus, the growth of the external debt slows the improvement in the current account and adds impetus to the downward trend in the dollar. At the same time, the increasing external debt reduces the share of domestic production that goes to residents of the United States. Both factors reduce the growth of real incomes.

Financial market pressures associated with the "twin deficits"--the external and federal deficits--may also make it harder to reduce real interest rates to the historical average by the end of the medium-term projection period. Most analysts believe that the large federal deficit coupled with low private saving increase interest rates, though the openness of the economy to international capital flows weakens this argument somewhat.[10] Thus, although the economic projections for the 1990-1994 period are not based on any particular fiscal policy, the declining interest-rate path that they show is prob-ably more consistent with a fiscal policy that makes substantial prog-ress toward reducing the federal deficit than with the fiscal policy implied in the baseline budget estimates.

10. Some theorists believe that private saving adjusts to changes in public saving without the need for interest-rate changes. See Robert J. Barro, "Are Government Bonds Net Wealth?" *Journal of Political Economy*, vol. 82 (November/December 1974), pp. 1095-1117. The evidence in support of this view is mixed, however.

Taxable Income

The outlook for wages and salaries, corporate profits, and other forms of taxable income (proprietors' income, and personal dividend and interest income) form an important part of CBO's economic forecast and projections. Tax revenues are projected on the basis of the forecast values of these income variables.

The forecast for taxable incomes in 1988 and 1989 is much higher than last winter's forecast (see Table I-6). This increase is partly the result of a major upward revision of the 1987 wages and salaries estimates in the national income accounts. (These revisions were not available to the Administration at the time of the midsession review, and thus are not reflected in the income assumptions underlying the Administration's most recent budget estimates.) Also, the stronger-than-expected economy in the first half of 1988 produced large increases in wages and salaries and corporate profits as percentages of GNP.

In the short term, the growth rates of wages and salaries and of corporate profits are expected to drop off slightly from their early 1988 pace, resulting in slight declines in their shares of GNP. The decline in the growth of wages and salaries largely reflects much slower employment growth. Growth in profits is restrained by higher interest rates and slower dollar depreciation. Other taxable income is expected to increase as a share of GNP, as higher interest rates generate greater personal interest income.

In the medium-term projections, rising real wages cause wages and salaries to increase as a percentage of GNP, while falling interest rates cause the share of other taxable income to fall, reflecting slower growth in interest income. Corporate profits also fall as a percentage of GNP, mainly because higher real wages more than offset the gain from lower interest rates.

The share of total taxable income in GNP falls throughout the medium-term projections (see Tables I-7 and I-8). This decline can be attributed to the pattern of the federal government's net interest payments and interest paid by consumers to business. These two variables form a part of taxable income, yet are excluded from national

TABLE I-9. COMPARISON OF ADMINISTRATION, CBO, AND *BLUE CHIP* SHORT-RUN ECONOMIC FORECASTS (By calendar year)

	Assumed[a] 1987	Forecast 1988	Forecast 1989
Fourth Quarter to Fourth Quarter (Percent change)			
Real GNP			
Administration	4.0	3.0	3.3
CBO	5.0	2.6	2.7
Blue Chip	5.0	3.0	1.9
Nominal GNP			
Administration	7.4	6.6	7.1
CBO	8.3	6.4	7.0
Blue Chip	8.3	6.6	6.3
Consumer Price Index			
Administration[b]	4.6	4.2	3.9
CBO[b]	4.5	4.4	5.0
Blue Chip[c]	4.5	4.4	5.0
Calendar-Year Averages (Percent)			
Three-Month Treasury Bill Rate			
Administration	5.8	6.0	5.5
CBO	5.8	6.3	7.1
Blue Chip	5.8	6.5	7.0
Ten-Year Government Note Rate			
Administration	8.4	8.5	8.1
CBO[d]	8.4	8.9	9.1
Blue Chip[e]	8.4	8.9	8.9
Civilian Unemployment Rate			
Administration[f]	6.1	5.5	5.2
CBO	6.2	5.5	5.5
Blue Chip	6.2	5.5	5.5

SOURCE: Congressional Budget Office; Office of Management and Budget; Eggert Economic Enterprises, Inc., *Blue Chip Economic Indicators* (August 10, 1988).

a. The national income data for 1987 were revised in July. The CBO and *Blue Chip* forecasts incorporate that revision, but the Administration forecast was prepared before the revision.

b. Consumer Price Index for urban wage earners and clerical workers.

c. Consumer Price Index for all urban consumers.

d. Ten-year constant-maturity bond rate.

e. *Blue Chip* does not project a 10-year note rate. The values shown here are based on the *Blue Chip* projection of the AAA bond rate, adjusted by CBO to reflect the estimated spread between AAA bonds and 10-year government notes.

f. The Administration's projection is for the total labor force, including armed forces residing in the United States, while the CBO and *Blue Chip* projections are for the civilian labor force excluding armed forces. In recent years, the unemployment rate for the former has tended to be 0.1 to 0.2 percentage point below the rate for the civilian labor force alone.

income, which counts only income derived from current production. Thus, with interest rates declining in the medium term--if other things remain the same--taxable income will be reduced as a share of national income. Furthermore, if progress on reducing the budget deficit proves to be better than assumed in the CBO baseline, total taxable income as a percentage of GNP will decline further, the result of lower debt-servicing requirements.

Uncertainty in the Forecast and Projections

The short-run economic forecast represents only one of many possible paths the economy might take. In CBO's judgment, it lies roughly in the middle of an array of possible paths.

Many forecasters accept the general line of argument presented here--that the Federal Reserve will restrain the growth of the economy--but they doubt that this slowing can be achieved smoothly. Some forecasters also believe that foreign investors are less sanguine about the dollar than assumed here, and that this will tend to force U.S. interest rates higher. For these reasons, several private econometric forecasters expect interest rates to be substantially higher than those in the CBO short-term forecast, and growth rates to be lower.

Other forecasts (for example, the Administration's midyear projections shown in Table I-9) predict less inflation and stronger growth. Such forecasts rest on a more optimistic assessment of the labor market, suggesting less monetary restraint without risk of higher wage inflation. Real growth could then be somewhat higher, and interest rates substantially lower.

Inflation and monetary policy do not exhaust the sources of uncertainty. Other major factors include the drought, which has yet to run its course, and unanticipated shocks to the economy. Finally, as noted previously and described in Appendix A, the changing shape of the economy, and particularly the increasing importance of the computer sector, add to the problems of forecasting. The general issue of uncertainty in economic forecasts is discussed in Appendix C of the Congressional Budget Office's *The Economic and Budget Outlook: Fiscal Years 1989-1993* (February 1988).

CHAPTER II

THE BUDGET OUTLOOK

Under current tax and spending policies, the federal budget deficit will shrink slowly over the next six years. The Congressional Budget Office projects that the deficit will fall from $155 billion in 1988 to $148 billion next year and $121 billion in 1994. The gap between federal government spending and revenues exceeds the targets set in the Balanced Budget Reaffirmation Act by widening amounts (see Figure II-1).

Because the nation's economy continues to grow over the next six years, the deficit shrinks steadily as a share of gross national product. By 1994, the deficit represents about 1.7 percent of GNP--about half its current portion and only one-third of the share that prevailed in the mid-1980s. Nevertheless, by historical standards, the deficit remains high: even as it slips below 2 percent in the early 1990s, the deficit-to-GNP ratio approximately matches its share during the economically troubled 1970s and far exceeds typical levels of the 1950s and 1960s.

The deficit's persistence in the face of the second-longest postwar economic expansion makes it clear that the fiscal imbalance is structural. Even with the economy running at or near full steam, federal government tax collections do not cover spending.

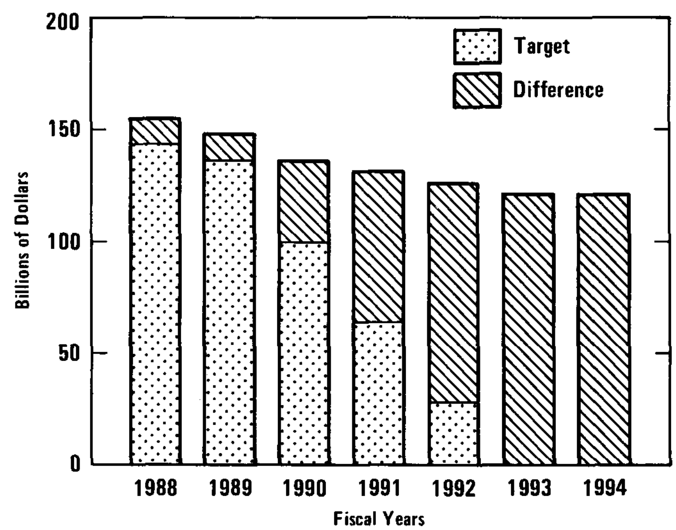
Persistent deficits imply continued demand by the U.S. government on credit markets: debt held by the public--now about $2 trillion--would grow to $2.8 trillion by 1994. With a relatively low private saving rate--as pointed out in Chapter I--the deficit further constricts overall domestic saving. Adding to the domestic capital stock and strengthening the nation's trade position will prove difficult as long as the low saving rate persists.

Policymakers and the public are focusing increased attention on Social Security's role in the budget and the economy. Social Security contributes greatly to the deficit's decline during the next six years, as shown in Figure II-2. The Social Security surplus climbs from $39 billion in 1988 to $113 billion in 1994, while the deficit in the remainder of the budget actually grows.

The budget outlook has brightened since CBO last published its projections. Last winter, CBO projected that the deficit would worsen in both 1988 and 1989 before finally declining. The economy's strength accounts for nearly all of the improvement. The slowdown expected by CBO and many other forecasters in the wake of last fall's stock market crash did not occur: GNP grew healthily, and the unemployment rate declined. Interest rates rose, but CBO had anticipated this development.

None of the deficit's improvement stems from policy decisions. Of the two major pieces of legislation affecting the budget enacted since last winter, one--the expansion of the Medicare program to cover catastrophic health care costs--affects revenues and spending about equally. The second--the recently enacted drought relief bill--adds about $5 billion to the deficit in 1989, offsetting most of the drop that would otherwise occur in federal government agricultural spending. Most appropriations bills (which cover roughly 40 percent of federal

Figure II-1.
CBO Deficit Projections Compared With Targets



SOURCE: Congressional Budget Office.

NOTE: The Balanced Budget Reaffirmation Act sets deficit targets only through 1993, for which the target is zero.

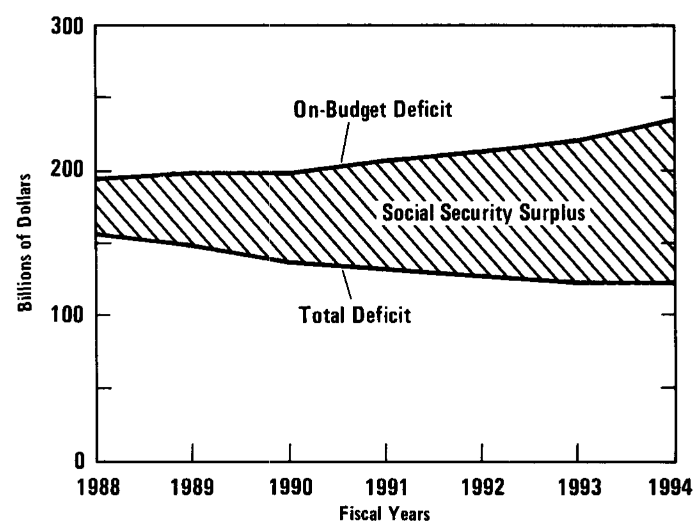
spending) have not yet been enacted for next year, although they are well along in the legislative pipeline. Modest savings could result from holding appropriations growth below inflation, the increase assumed by CBO in the absence of an enacted bill. But other initiatives currently under consideration--such as an expanded war on drugs--could increase 1989 spending.

Besides changes in the economic outlook and enacted legislation, a variety of other factors has affected the spending and revenue outlook. On balance, these other revisions worsen the deficit slightly in most years and are discussed in more detail later.

THE SHORT-RUN BUDGET OUTLOOK

The federal government deficit is projected to be $155 billion in fiscal year 1988, which ends on September 30. For 1989, the deficit under current policies is projected to be $148 billion, although this projection is more uncertain. Economic performance is always hard to forecast,

Figure II-2.
Social Security and the Budget



SOURCE: Congressional Budget Office.

and many other factors affect federal spending and revenues. Furthermore, the Congress and the President must still enact many bills that will influence the 1989 budget. Table II-1 summarizes the short-run projections of revenues, spending, and the deficit.

Both 1988 and 1989 will virtually match 1987's tally: last year, the deficit was $150 billion, well below initial projections. But a first-year revenue boost from tax reform, along with a number of one-time outlay savings (such as asset sales), contributed heavily to 1987's result. These factors are absent in 1988 and 1989. Thus, the relative stability of the deficit over this three-year period masks a slow but steady underlying improvement.

Fiscal Year 1988

With three-quarters of the fiscal year over, CBO now expects fiscal year 1988 revenues to total $908 billion and outlays to reach $1,063 billion, with a resulting deficit of $155 billion. The estimate has changed relatively little since last March, when CBO projected a deficit of $161 billion. The economy turned in a strong performance in the first half of the year, leading many economists who had foreseen a slowdown or recession to worry instead about high interest rates and a possible resurgence of inflation. The economy's strength boosted revenues and reduced spending for unemployment insurance. Interest

TABLE II-1. THE SHORT-RUN BUDGET OUTLOOK (By fiscal year, in billions of dollars)

	Actual		Estimate	CBO Baseline	Base for Balanced Budget Act
	1986	1987	1988	1989	1989
Revenues	769	854	908	980	980
Outlays	990	1,005	1,063	1,127	1,133
Deficit	221	150	155	148	153

SOURCE: Congressional Budget Office.

rates rose slightly less than CBO had anticipated, helping to hold down interest outlays.

While the economy's performance--along with the drought, which holds down agriculture spending--helps 1988's bottom line, several other factors have worsened the deficit since CBO last published its projections in March. Spending is higher for national defense (almost $6 billion), deposit insurance ($3 billion), and defaults on mortgages insured by the Federal Housing Administration ($1 billion). Corporate income tax collections came in sharply below projections, failing to keep pace with economic profits. Finally, CBO had expected prepayments of some Foreign Military Sales program loans--permitted under last December's continuing resolution--to occur entirely in 1988. (Prepayments are recorded as negative outlays, thus reducing total spending.) It now appears that some payments will not occur until 1989, raising this year's outlays by $3 billion.

Fiscal Year 1989

For 1989, CBO has revised its deficit estimate substantially downward. Last March, CBO projected a 1989 deficit of $177 billion; current estimates point to $148 billion.

Economic factors dominate the revisions, raising 1989 revenues by $29 billion and lowering outlays by $6 billion. The reduction in outlays reflects lower unemployment insurance costs, slightly lower cost-of-living adjustments in benefit programs (most of which will be determined before the drought significantly affects consumer prices), and lower debt service costs. The additional revenues mostly come from higher personal income and payroll taxes.

Recently enacted legislation raises the 1989 deficit by $5 billion, mainly reflecting the drought relief bill. All other factors--commonly termed technical revisions--have little net impact for 1989. This is because the technical revisions include two special factors in 1989, both of which reduce outlays. First, in the absence of special legislation to aid farmers, the drought would have shrunk 1989 agriculture outlays by an estimated $7 billion (see Box II-1). Second, Foreign Military Sales prepayments are now pegged at $5 billion in 1989;

BOX II-1
THE DROUGHT OF 1988

Parched conditions in much of the nation have reduced agricultural production, driven up prices, and lowered projections of federal government spending for agriculture programs. In the absence of special relief legislation, the drought would cause government spending on agriculture to decline by $3.8 billion from previous projections in 1988 and by $6.9 billion in 1989. Much of 1989's drop, however, is restored by the newly enacted drought relief legislation. These estimates are based on crop conditions in early August. Next season's crops are assumed to face average weather conditions. The estimated effect of the drought on federal outlays may change as more becomes known about its severity and as requests for disaster aid are processed.

The drought greatly reduces outlays of the Commodity Credit Corporation (CCC), while causing smaller increases in outlays for crop insurance and Farmers Home Administration loan programs. The Disaster Assistance Act of 1988 (Public Law 100-387) boosts spending in all three areas, but primarily in CCC programs. Because it affects the economy, the drought also indirectly influences federal government revenues and nonagriculture spending (such as indexed benefit programs).

Farm Price Supports. The CCC operates the government's major price and income support programs for farmers. Without drought relief legislation, CCC spending would be $12.3 billion in 1988 ($4.7 billion below last February's estimate) and $8.9 billion in 1989 (down $8.5 billion from February). Most of the drop in outlays stems from the drought. Offsetting part of the reduction, the Disaster Assistance Act raises CCC spending by an estimated $4.5 billion next year, resulting in net CCC spending of $13.4 billion in 1989.

The drought and scorching heat cause lower production and higher prices for crops. The corn crop is projected to be about 36 percent below levels expected at the start of the season, and the soybean crop is projected to be down about 18 percent. Corn prices are assumed to be about $1 per bushel higher than they would be with normal weather, and soybeans about $2.20 per bushel higher. The drought wiped out over half of the nation's spring wheat crop, although the larger winter wheat harvest was unaffected.

As explained in a recent CBO report, *The Outlook for Farm Commodity Program Spending, Fiscal Years 1988-1993* (June 1988), a drought has several impacts on CCC spending. First, rising market prices reduce direct payments to farmers. These payments--termed deficiency payments--roughly make up the difference between actual market prices and higher target prices set by law for certain commodities. As market prices rise, the government's

Continued

deficiency payment per pound or bushel falls. Second, farmers pay back CCC loans and reclaim the crops that they pledged as collateral. Farmers gain by doing so whenever the market price rises above the CCC loan rate. Finally, the government may sell some of its commodity stockpiles in the market, mitigating the drought's pressure on prices. Receipts from such sales, of course, reduce total outlays. By selling its stocks, however, the government limits the upward movement in market prices and gives up some of the savings from lower deficiency payments. Commodity sales therefore actually boost total outlays.

Many farmers found their incomes drying up along with their crops; with government payments reduced, only those farmers with crops to sell could benefit from higher market prices. Widespread sympathy for farmers led the Congress to enact the new Disaster Assistance Act. Under the act, CCC will provide disaster payments to producers who have suffered major crop damage--including crops not ordinarily enrolled in CCC programs--and will aid certain livestock and dairy producers facing higher feed prices.

Projections of future CCC spending require assumptions about such factors as the weather, supply and demand for agricultural commodities, and the international economy. Updating CBO's June 1988 report, Appendix B presents some of the key assumptions underlying CBO's projections for 1988 through 1994.

Crop Insurance and Disaster Loans. Two other major programs operated by the U.S. Department of Agriculture face higher outlays because of the drought. Estimated Federal Crop Insurance Corporation (FCIC) outlays have increased by $0.4 billion in 1988 and $1.1 billion in 1989. Crop insurance protects farmers' incomes in the case of either local or widespread disaster. The program is heavily subsidized; nevertheless, only about one-fifth of eligible cropland is enrolled. The drought relief bill requires some farmers receiving disaster payments to enroll in FCIC next year.

Net outlays in the farmer loan programs of the Farmers Home Administration (FmHA) are also expected to rise. The financial hardship inflicted by the drought will reduce loan repayments, and will increase disbursements of disaster loans. Before the passage of the drought relief bill, only farmers covered by crop insurance, where it is available, could receive FmHA disaster loans, limiting the increase in such activity. The drought bill expanded eligibility. Compared with pre-drought estimates, net outlays for the farmer loan programs are higher by $0.4 billion in 1988 and $1.2 billion in 1989, with $500 million of the 1989 increase attributable to the drought relief bill.

earlier, they were assumed to occur entirely in 1988. These two factors suffice to offset other technical revisions that lower revenues (primarily corporate income taxes) and raise spending, mainly for defense and deposit insurance.

Progress on the 1989 Budget. In mid-August, with the start of the fiscal year still a month and a half away, the 1989 budget is not fully in place. Roughly 40 percent of the budget is funded through annual appropriations. Only one of the 13 regular appropriations bills, the Energy and Water Bill, has been enacted. However, the remaining 12 bills are well advanced in the legislative pipeline: one awaits the President's signature, two have emerged from conference committees, and the rest have separately passed the House and Senate and await conference action.

Besides the remaining appropriations bills, other legislation with budgetary effects may be enacted by October, when the Congress intends to adjourn. Among other areas, the Congress is actively considering welfare reform, expansion of the war on drugs, technical corrections to the 1986 Tax Reform Act, and other tax law changes.

The budget projections for 1989 reflect all legislation enacted to date. For programs funded in appropriations bills, but whose appropriation has not yet been enacted, CBO assumes an increase over the 1988 amount to keep pace with inflation (estimated to be 4.2 percent). Appropriations bills and other pending legislation will be crucial in determining compliance with the Balanced Budget Act in fiscal year 1989.

The Balanced Budget Reaffirmation Act of 1987. Last September, the Congress amended the Balanced Budget and Emergency Deficit Control Act of 1985, commonly referred to as Gramm-Rudman-Hollings. The new law sets a deficit target of $136 billion for fiscal year 1989; the target declines in steps until 1993, when the budget is to be in balance. The act requires automatic across-the-board cutbacks in spending if official estimates indicate that the targets appear unlikely to be reached, allowing for a $10 billion margin. Events between now and mid-October will determine the law's effect on the budget for fiscal year 1989.

The original Balanced Budget Act failed to pass constitutional tests because of the role it gave to the head of the General Accounting Office, a legislative branch agency, in determining cutbacks. The amended act puts the entire responsibility for estimating and carrying out the cutbacks squarely on the Office of Management and Budget. CBO, however, plays an advisory role. OMB's deficit projections for fiscal year 1989 are lower than CBO's, lessening the likelihood of sequestration.

On August 25, OMB must issue an official projection of the deficit under policies in place in mid-August. Previewing this estimate, OMB's midsession review in late July put the 1989 deficit (as measured under the Balanced Budget Reaffirmation Act) at $140 billion--about $6 billion below the effective target of $146 billion (the official $136 billion requirement plus the $10 billion margin). The drought bill has since added roughly $4 billion to this figure, according to OMB estimates. (OMB's midsession review was predicated on a less severe drought than assumed by CBO; thus, OMB assigns a lower cost to drought relief.) OMB must make a second, binding estimate of the deficit in mid-October. If policy changes enacted before mid-October do not push the deficit over $146 billion, in OMB's estimate, sequestration will not occur. Nevertheless, if sequestration is triggered, the $10 billion margin is irrelevant, and the cuts must be calibrated to reach a deficit of $136 billion. Policy changes include all legislation enacted during the two-month period--such as final appropriations bills and other laws--as well as regulatory actions.

According to CBO's estimates, the 1989 deficit would not meet the target without further savings. CBO's own estimates of the 1989 deficit and necessary program-by-program cutbacks--contained in a separate report required by the act--will be sent to the Congress and to the Director of OMB on August 20. CBO estimates the 1989 deficit for purposes of the act to be nearly $153 billion. As shown in Table II-2, this figure removes approximately $5 billion in receipts from loan prepayments from the baseline deficit, receipts that may not be counted under the Balanced Budget Act. Under CBO estimates, reaching the act's $136 billion target wholly through sequestration would require across-the-board cuts of about 7 percent in defense and about 6 percent in nondefense, nonexempt programs.

TABLE II-2. DIFFERENCES BETWEEN CBO BASELINE AND ESTIMATED DEFICIT FOR PURPOSES OF THE BALANCED BUDGET ACT, FISCAL YEAR 1989 (In billions of dollars)

CBO Baseline Deficit	147.6
Remove:	
Foreign Military Sales prepayments	4.7
Rural Electrification Administration prepayments	0.5
Subtotal	5.2
CBO Estimate of Deficit for Balanced Budget Act	152.8

SOURCE: Congressional Budget Office.

THE BUDGET OUTLOOK THROUGH 1994

Under current policies, the federal government's deficit will decline slowly over the next six years. The decline is not swift enough to meet the targets set in the Balanced Budget Act, which calls for a balanced budget by 1993. Table II-3 summarizes the baseline projections through 1994.

The Baseline Concept

CBO prepares baseline budget projections to show the consequences of leaving current budgetary policies unchanged. The projections are consistent with the two-year economic forecast and the longer-run economic assumptions outlined in Chapter I, and follow the assumptions about federal spending and taxes specified in the Balanced Budget Act. Estimates of revenues and entitlement spending (such as Social Security and Medicare) are based on current laws. The growth in revenues and entitlement programs thus depends on provisions set in law (for example, tax rates and benefit formulas), on the economy, and on a variety of other factors.

In a few select cases, the projections depart from current law by assuming the extension of expiring provisions. Three entitlement programs--Food Stamps, Guaranteed Student Loans, and Trade Adjustment Assistance--are assumed to continue after their scheduled expirations. (Excluding these programs--especially the first two--would ignore billions of dollars in spending that is likely to be reauthorized.) On the revenue side, excise taxes dedicated to five trust funds (the Airport and Airway Trust Fund, the Highway Trust Fund, the Leaking Underground Storage Tank Trust Fund, the Hazardous Substance Superfund, and the Vaccine Injury Compensation Trust Fund) are extended after their scheduled expirations in the 1990s. (Required by the Balanced Budget Reaffirmation Act, this assumption also mirrors the traditional treatment in baseline projections of major trust funds.) All other spending programs and tax provisions that expire under current law are assumed to expire.

TABLE II-3. CBO BASELINE PROJECTIONS OF REVENUES, OUTLAYS, AND DEFICITS (By fiscal year)

	1988	1989	1990	1991	1992	1993	1994
	In Billions of Dollars						
Revenues	908	980	1,064	1,134	1,202	1,276	1,354
Outlays	1,063	1,127	1,200	1,265	1,329	1,397	1,475
Deficit	155	148	136	131	126	121	121
Debt Held by the Public	2,031	2,178	2,313	2,441	2,566	2,686	2,806
	As a Percentage of GNP						
Revenues	19.0	19.2	19.6	19.6	19.5	19.4	19.4
Outlays	22.3	22.1	22.1	21.8	21.5	21.3	21.1
Deficit	3.2	2.9	2.5	2.3	2.0	1.8	1.7
Debt Held by the Public	42.6	42.7	42.5	42.2	41.6	40.9	40.1
	In Billions of Dollars						
Reference: Balanced Budget Act Deficit Targets (Billions of dollars)	144	136	100	64	28	0	a

SOURCE: Congressional Budget Office.

a. The Balanced Budget Act sets deficit targets only through fiscal year 1993.

As for entitlements, the projections of offsetting receipts (for example, receipts from Medicare premiums and from oil leases) are estimated according to current law and policy. Estimates of net interest costs are consistent with the assumed interest rates and deficits.

Unlike the categories just mentioned, many activities of the federal government are funded by annual appropriations acts. The projections assume that funding increases each year in line with inflation--that is, by 4.2 percent in fiscal year 1989 and by similar percentages in 1990 through 1994. (An exception is programs covered by the only fiscal year 1989 appropriations bill enacted to date; programs funded in the Energy and Water Bill reflect the enacted 1989 amount, and are increased for inflation beginning in 1990.)

The authors of the Balanced Budget Act sought a uniform approach for projecting all appropriated activities. For that reason, the baseline does not contain year-to-year fluctuations in funding levels to accommodate special program needs (for example, the 1990 Census).

Except for the year already in progress, the baseline is not a forecast of budget outcomes. The baseline's major purpose is to serve as a benchmark when considering alternative budget policies. Almost all participants in budget debates use baseline projections as a starting point for gauging policy changes. The Congress typically describes initiatives in terms of changes from a baseline; the Administration portrays its budget proposals in similar terms. Other groups--such as the new National Economic Commission, scheduled to make its recommendations around the turn of the year--also use such projections to launch their examination of budget priorities.

The Six-Year Budget Outlook

Over the next six years, revenues under current tax law, given CBO's economic assumptions, average about 19.4 percent of GNP. Baseline outlays decline steadily as a share of GNP, from 22.3 percent in 1988 to 21.1 percent in 1994. As a result, the deficit falls relative to GNP even while remaining above $120 billion in dollar terms. Detailed projections of revenues by source and outlays by category are provided in Table II-4.

TABLE II-4. CBO BASELINE BUDGET PROJECTIONS (By fiscal year)

	1988	1989	1990	1991	1992	1993	1994
			In Billions of Dollars				
Revenues							
Individual income	405	433	477	514	551	590	629
Corporate income	91	107	119	126	131	136	143
Social insurance	335	360	386	412	436	464	493
Excise	35	34	34	31	30	31	31
Estate and gift	8	8	8	8	8	9	9
Customs duties	15	16	17	19	20	22	23
Miscellaneous	20	22	23	24	25	25	26
Total	908	980	1,064	1,134	1,202	1,276	1,354
Outlays							
National defense	293	300	310	322	335	348	363
Nondefense discretionary spending	178	190	204	208	217	223	234
Entitlements and other mandatory spending	498	535	573	614	656	702	754
Net interest	151	163	178	188	192	198	202
Offsetting receipts	-57	-61	-64	-67	-71	-75	-78
Total	1,063	1,127	1,200	1,265	1,329	1,397	1,475
Deficit	155	148	136	131	126	121	121
			As a Percentage of GNP				
Revenues							
Individual income	8.5	8.5	8.8	8.9	8.9	9.0	9.0
Corporate income	1.9	2.1	2.2	2.2	2.1	2.1	2.0
Social insurance	7.0	7.1	7.1	7.1	7.1	7.1	7.1
Excise	0.7	0.7	0.6	0.5	0.5	0.5	0.4
Estate and gift	0.2	0.2	0.1	0.1	0.1	0.1	0.1
Customs duties	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Miscellaneous	0.4	0.4	0.4	0.4	0.4	0.4	0.4
Total	19.0	19.2	19.6	19.6	19.5	19.4	19.4
Outlays							
National defense	6.1	5.9	5.7	5.6	5.4	5.3	5.2
Nondefense discretionary spending	3.7	3.7	3.7	3.6	3.5	3.4	3.3
Entitlements and other mandatory spending	10.4	10.5	10.5	10.6	10.6	10.7	10.8
Net interest	3.2	3.2	3.3	3.2	3.1	3.0	2.9
Offsetting receipts	-1.2	-1.2	-1.2	-1.2	-1.2	-1.1	-1.1
Total	22.3	22.1	22.1	21.8	21.5	21.3	21.1
Deficit	3.2	2.9	2.5	2.3	2.0	1.8	1.7

SOURCE: Congressional Budget Office.

NOTE: Totals include Social Security, which is off-budget.

The Revenue Outlook. Expected to total 19 percent of GNP in 1988, revenues grow to 19.2 percent of GNP in 1989 and climb again, to 19.6 percent, in 1990. Strong growth in taxable income causes revenues to outpace GNP in 1989; in 1990, the increase reflects phased-in provisions of revenue legislation. After 1991, revenues shrink slightly relative to GNP, as growth in corporate income taxes, unemployment insurance taxes, excise taxes, and estate and gift taxes tapers off. By 1993, revenues are projected to total 19.4 percent of GNP (see Table II-4).

As just noted, the growth in revenues between 1989 and 1990 (from 19.2 percent to 19.6 percent of GNP) results from recent and not-so-recent legislation. Reductions in individual income taxes under the 1986 Tax Reform Act are largest in 1989, but diminish thereafter as the base-broadening provisions of the act are phased in. Additional revenues from the act's corporate income tax provisions also become more important in 1990. The income tax surcharge under the new catastrophic health insurance program generates less than $0.5 billion in 1989, but is fully in place in the next year, raising over $4 billion in 1990. A Social Security tax rate increase--contained in a 1983 law--also takes effect on January 1, 1990, increasing 1990 reve-nues by about $5 billion.

Tax law changes are less important after 1990, mainly contributing to a small reduction in the corporate tax share. Unemployment insurance taxes actually decline in dollar terms, as healthy balances in the unemployment trust funds enable many states to reduce their tax rates; excise and estate and gift tax collections fail to keep pace with GNP growth. Because of these relatively slow-growing sources, revenues' share of GNP declines slightly after the turn of the decade. Between 1988 and 1994, personal income taxes and Old-Age and Survivors, Disability, and Hospital Insurance (OASDHI) taxes provide increasing shares of the government's total revenues--over four-fifths in 1994. Corporate income taxes continue to provide somewhat more than a tenth, and other tax sources, taken as a whole, decline slightly in relative importance.

The Outlook for Federal Spending. The bulk of federal spending represents benefit payments to individuals, interest on the debt, and similar programs that are governed by permanent law. Less than half of all spending is actually decided through the annual appropriations debate. In the baseline, the share devoted to these latter activities--termed defense and nondefense discretionary spending--shrinks further, as Table II-4 shows.

In the baseline, appropriations are assumed to rise only in step with inflation; thus, unlike the economy and other parts of the budget, they have no real growth. Under this assumption, defense spending would fall from 6.1 percent of GNP at present to 5.2 percent by 1994--about the level that predated the defense buildup of the early 1980s. Nondefense discretionary spending encompasses a broad variety of government activities: from transportation, veterans' medical care, and the expenses of the Internal Revenue Service to space and science, to name only a few. About a fifth of nondefense discretionary spending goes toward pay and benefits for federal workers, and about a third is sent out as grants to state and local governments. In the baseline, nondefense discretionary spending declines from 3.7 percent of GNP at present to 3.3 percent by 1994.

By adjusting all programs equally for inflation, the baseline preserves the current priorities in both defense and nondefense discretionary programs. Proposals to change the mix of existing programs (for example, to deemphasize defense procurement in favor of funding for operation and maintenance), to cut back or eliminate activities, or to spend more on needs widely perceived as urgent (such as air traffic control or aid to the homeless) can all be gauged in terms of changes from the baseline.

Entitlements and other mandatory spending are the largest category of federal outlays, representing about half of total outlays and more than a tenth of GNP. This category includes almost all of the major benefit programs such as Social Security, Medicare and Medicaid, and federal civilian and military retirement. It also includes certain other programs like farm price supports and deposit insurance. The common thread linking these programs is their nearly automatic nature: instead of deciding on funding levels each year, the Congress sets eligibility rules and payment formulas. As Table II-4 shows, under current law, entitlements and mandatory spending grow gradually from 10.4 percent of GNP in 1988 to almost 11 percent in 1994. Some of the fastest-growing entitlements are examined further below.

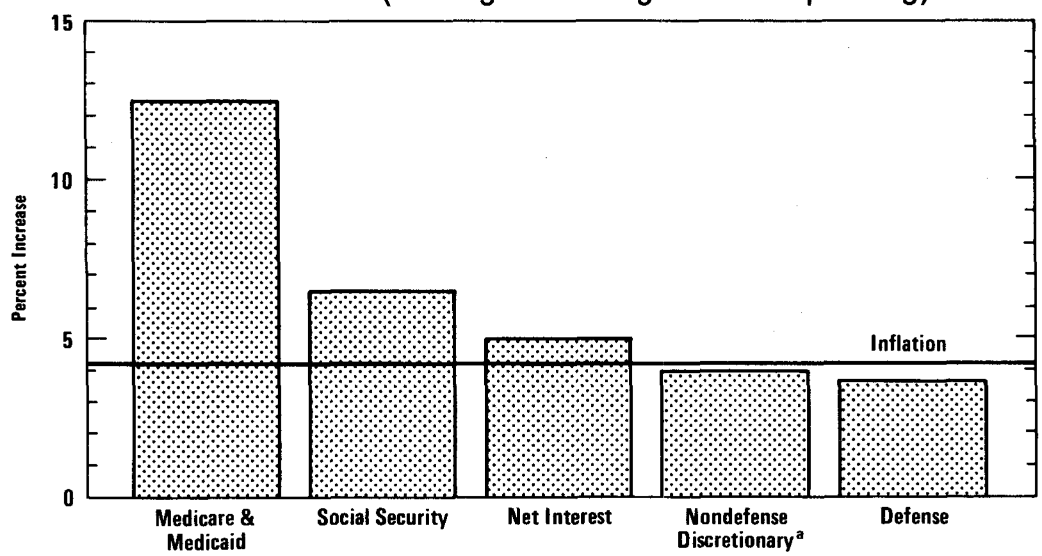
Net interest payments grew rapidly during the late 1970s and early 1980s, the consequence first of high interest rates and then of large deficits. Net interest now represents about a seventh of federal spending and 3.2 percent of GNP. Interest costs decline very slightly as a share of GNP in the baseline projections, even as the government continues to borrow $120 billion a year or more to finance its deficits. The slight decline stems from the leveling-off of federal debt as a share of GNP (as shown in Table II-3), and from continued savings from the refinancing of debt borrowed at the higher interest rates of the early and mid-1980s. Nevertheless, interest remains one of the most volatile categories of federal spending. Relatively small errors in the interest rate forecast imply large errors in projected net interest spending, as illustrated later in this chapter.

Some federal government receipts are recorded as negative outlays, rather than as revenues. This category--termed offsetting receipts--stays at about 1.2 percent of GNP throughout the projections. More than half of offsetting receipts consist of government agencies' contributions for their employees' retirement; while the agencies' costs are included in their budgets, the money does not immediately leave the government, and a negative amount is logged to balance the books. Other offsetting receipts stem from business transactions such as payments for optional Medicare coverage, oil and mineral leases, timber sales, and sales of hydroelectric power. All of these receipts stem from voluntary transactions, and are not generated by the government's taxing power.

The federal budget clearly contains both fast- and slow-growing programs; as a result, the baseline reflects gradual shifts in the shares of government spending attributable to particular activities. As Figure II-3 shows, the two large health-care entitlements--Medicare and Medicaid--are the fastest-growing major category of federal spending, with growth projected to average more than 12 percent a year. Medicare, a non-means-tested program, covers a portion of medical expenses for most of the nation's elderly and some of its disabled. Medicare benefits include Hospital Insurance, Supplementary Medical Insurance (primarily covering physicians' charges), and--starting in 1990--the new Drug Insurance program. Major factors underlying Medicare's growth include growth in the eligible population, high medical care inflation, greater use of medical services by the average beneficiary, and the new expansion of catastrophic health care. Medicaid, a joint federal/state program, pays some medical costs for the needy. Major factors fueling Medicaid's growth include medical care inflation; increases in the population receiving long-term care; and expanded eligibility for some pregnant women, children, and the elderly. Currently about half as big as Social Security, Medicare and Medicaid combined grow to almost three-quarters of the size of Social Security by 1994, under current policies.

Total outlays for Social Security benefits climb about 6.5 percent a year through 1994, driven by cost-of-living adjustments, additional beneficiaries, and greater average benefits for new retirees with recent earnings. While Social Security continues to hold second place among the categories of spending shown in the figure--defense spending is larger in all years--this sustained growth makes it an ever more important component of the budget. (Although they are not shown in

Figure II-3.
Selected Fast- and Slow-Growing Programs, Fiscal Years 1988-1994 (Average annual growth in spending)



SOURCE: Congressional Budget Office.

[a] Excludes one-time savings.

the figure, other retirement and disability programs--mainly federal civilian and military retirement--are about one-fourth as large as Social Security, and grow almost as fast.) Next comes interest spending; fueled by continued government borrowing, interest payments climb rapidly at first and more slowly after 1991, averaging growth of about 5 percent a year during the six-year period. Both defense and nondefense discretionary spending, at annual growth averaging 3 percent to 4 percent, fall in the slow-growing category; because of lags between appropriations and actual spending, they grow in the baseline by slightly less than inflation.

Trust Funds in the Projections. The federal government operates many trust funds, ranging from the small (the Abraham Lincoln Birthplace Preservation Trust Fund) to the enormous (Social Security and Civil Service Retirement). In these funds, income is earmarked for particular types of spending. The reasons for establishing trust funds, and features that distinguish trust funds from other government funds, are summarized in Box II-2. Trust fund surpluses climb steadily for the next six years under current policies, while the deficit in the remainder of the budget (termed "federal funds") actually grows. As Table II-5 shows, led by Social Security, by 1994 the annual trust fund surplus reaches $174 billion (up from $100 billion in 1988), while the deficit in the rest of the budget attains $295 billion (up from $255 billion in 1988).

Trust funds vary widely in their size, sources of income, and expenditures. The biggest trust funds finance social insurance programs, and by far the largest--in terms of annual flows--is Social Security. Other large social insurance trust funds shown in Table II-5 include Medicare, Civil Service Retirement and Military Retirement, and Unemployment Insurance. The two major transportation trust funds--the Airport and Airway Trust Fund and the Highway Trust Fund--are smaller than the social insurance funds, although their cumulative surpluses are very large relative to annual spending.

Earmarked taxes are a major source of trust fund revenue. Many federal government collections--such as social insurance taxes and contributions, excise taxes on airplane tickets, and gasoline taxes--are designated for particular purposes. When collections exceed spending for these programs, the extra funds are lent to the U.S. Treasury. In this way, trust fund surpluses help to hold down the government's borrowing demands. In return, the Treasury issues securities to the trust funds. As Table II-5 shows, total trust fund holdings grow to almost $1.4 trillion by 1994.

The Social Security surplus climbs from $39 billion in 1988 to $113 billion in 1994, and holdings of federal securities reach almost $600 billion. These surpluses result from reforms enacted in 1977 and 1983, which raised payroll taxes in several steps and reduced benefits modestly. Proponents argued that large Social Security surpluses over the next few decades would help prepare for the baby boom's retirement, when--beginning around 2015--Social Security benefits should significantly exceed the system's taxes. The Social Security surpluses are termed off-budget to distinguish them from other gov-

BOX II-2
WHAT ARE TRUST FUNDS?

The federal government uses trust funds as a bookkeeping tool to keep track of income and spending for particular purposes. Most federal government trust funds were established for one of three reasons:

- To assure individuals making contributions that they are earning a right to future benefits (examples are Social Security and Hospital Insurance);
- To indicate that certain tax revenues will be spent for specific purposes (Highway, and Airport and Airway);
- To recognize certain costs when they accrue, not when cash benefits are paid (Military Retirement and Civil Service Retirement).

Trust funds are not the same as public enterprise funds, which also keep track of spending and collections associated with particular activities. Public enterprise funds--such as the Postal Service or the Tennessee Valley Authority--generally conduct business activities, selling services to the public and using the proceeds (and, often, a general fund subsidy) to cover their costs. Outlays for public enterprise funds are recorded on a net basis.

The two Social Security trust funds--Old Age and Survivors Insurance and Disability Insurance--are off-budget, meaning that their totals are reported separately from the rest of the budget. Nevertheless, a dollar of federal spending generally has the same macroeconomic impact regardless of whether it is termed on- or off-budget, and regardless of whether it is financed by a trust fund or from the general fund.

ernment programs, but are included in measures of the deficit used by most economists and financial market participants, as well as by the Congress in assessing compliance with the Balanced Budget Act targets. As the surpluses envisioned in the 1983 reforms have actually materialized, policymakers have joined a spirited debate over their implications for fiscal policies and targets. Box II-3 summarizes some of the issues in this debate.

Steady growth in trust fund surpluses may seem puzzling in light of the aggregate spending and outlay projections discussed earlier. After all, social insurance taxes and contributions--a major source of funding for trust funds--remain at about 7 percent of GNP. Social Security, Medicare, and federal civilian and military retirement--all of which are financed by trust funds--were identified as particularly fast-growing spending categories.

TABLE II-5. TRUST FUND SURPLUSES IN THE CBO BASELINE (By fiscal year, in billions of dollars)

	1988	1989	1990	1991	1992	1993	1994	Holdings, End of 1994
Social Security	39	52	63	74	86	99	113	591
Medicare	16	20	19	17	17	15	14	175
Military Retirement	14	16	16	17	18	18	19	149
Civilian Retirement	20	21	21	24	25	26	29	347
Unemployment	8	7	5	4	2	1	a	55
Highway and Airport	2	3	2	1	a	a	a	31
Other	a	-2	1	1	1	1	-1	48
Total Trust Fund Surplus	100	116	127	137	149	160	174	1,395
Federal Funds Deficit	255	264	263	269	275	281	295	n.a.
Total Deficit	155	148	136	131	126	121	121	n.a.

SOURCE: Congressional Budget Office.

NOTE: n.a. = not applicable.

a. Less than $500 million.

This paradox is resolved by recognizing the importance of transfers within the budget as a source of the trust fund surplus. Trust funds have many sources of income besides earmarked tax collections. Medicare's Supplementary Medical Insurance program, for example, currently gets about a fourth of its funds from voluntary enrollee premiums and most of the rest from general revenues. Both Civil Service Retirement and Military Retirement receive large lump-sum appropriations each year. One of the most important sources of trust fund income is interest on Treasury securities. As long as trust funds run surpluses, their holdings of Treasury securities and their interest income climb. Interest paid to trust funds grows from about $44 billion in 1988 to more than $100 billion in 1994. These interest payments are outlays of the general fund and account for much of the growth in the federal funds deficit.

Changes in the Projections Since March. CBO last published its baseline projections in March, using an economic forecast developed around the turn of the year. At that time, CBO projected that the deficit would worsen in 1988 and 1989 before gradually declining. The updated projections are more optimistic, especially after 1988.

Table II-6 shows why the budget projections have changed since March. Many of these reasons were discussed earlier in the special section on the short-term budget outlook. Little of the improvement in the deficit stems from policy changes. Of the two major pieces of budgetary legislation enacted to date, one--the catastrophic health care bill--has little effect on the deficit. Box II-4 contains a discussion of the benefits and financing provisions of this important legislation. The second, the drought relief bill, adds about $5 billion in spending for fiscal year 1989.

As noted earlier, changes resulting from the revised economic outlook reduce the deficit substantially in all years of the projection. Revisions in revenues dominate this category. Roughly 80 percent of the additional revenues in 1989 and 1990, and even more in later years, result from substantial upward revisions in personal income. (By 1993, they account for the entire upward revision.) The changes in personal income--primarily wages and salaries--raise both individual income taxes and Social Security taxes. Other changes in projected revenues attributable to revised economic assumptions are much

BOX II-3
SOCIAL SECURITY AND THE BUDGET

Roughly a fourth of the federal government's revenues, and a fifth of its spending, stem from the Social Security program. The budget projections in this chapter include Social Security revenues and outlays. Excluding Social Security--or any other government program--from the totals would distort the government's impact on the economy and misrepresent its borrowing needs. Recognizing this, the Balanced Budget Act set targets for the overall deficit, including Social Security. But the act also highlights Social Security's contributions to the totals by requiring that they be presented as off-budget. These projections are shown below.

ON- AND OFF-BUDGET TOTALS
(By fiscal year, in billions of dollars)

	1988	1989	1990	1991	1992	1993	1994
			Off-Budget (Social Security)				
Revenues	242	264	287	309	330	353	376
Outlays	203	212	224	235	245	254	263
Surplus	39	52	63	74	86	99	113
			On-Budget (All Other Programs)				
Revenues	666	716	778	824	872	923	978
Outlays	860	915	977	1,030	1,084	1,143	1,212
Deficit	194	199	199	206	212	220	234

SOURCE: Congressional Budget Office.

Off-budget outlays are not the same as Social Security benefit payments: benefits from the two trust funds--Old Age and Survivors Insurance and Disability Insurance--are much greater than the totals shown. Of course, off-budget outlays include these benefits and other trust fund outlays such as administrative costs. But as offsets, off-budget outlays also reflect some income received by Social Security from other federal agencies and programs. An especially fast-growing source is interest income: Social Security interest grows sixfold between 1988 and 1994, as shown in the following table, reflecting large increases in the funds' holdings of Treasury securities during the six-year period.

Continued

SOCIAL SECURITY INTEREST AND FUND HOLDINGS
(By fiscal year, in billions of dollars)

	1988	1989	1990	1991	1992	1993	1994
Interest Received by Social Security	7	11	16	21	28	34	42
Change in Holdings	39	52	63	74	86	99	113
Holdings, End of Year	105	157	219	294	379	478	591

SOURCE: Congressional Budget Office.

The growth in interest payments and, to a lesser extent, the increase in other intrabudgetary transactions helps to explain why the on-budget deficit climbs over the 1988-1994 period even while the overall budget picture improves. Much of the Social Security surplus does not reflect transactions with the public but transfers within the budget. The payment of interest to Social Security is a source of pressure on the on-budget deficit, just as if the funds had been borrowed from private bondholders.

Recognizing the long-run implications of Social Security as well as other programs, CBO has begun analyzing broad budgetary trends beyond its usual five-year horizon. But longer-run budget projections carry their own set of hazards. Some of the usual baseline assumptions may be too stringent for long-term projections. For example, increasing appropriations only for inflation allows defense and nondefense discretionary spending to continue to shrink as a share of GNP. The economic uncertainty of longer-run projections is also huge. Clearly, Social Security helps the budget picture through the mid-1990s and for some time beyond. Nevertheless, speculation by some observers that Social Security will buy up the federal debt is premature. Attaining budget balance merely keeps the debt from growing; buying back the existing debt would require years of surplus in the total budget.

Setting budgetary targets requires decisions about the government's contribution to total national saving. Balancing the overall budget would greatly increase national saving from current levels by removing the federal government's appetite for the savings of other sectors. Some advocate moving even beyond this goal by aiming for zero deficits in non-Social Security programs, implying large total surpluses. Sharply increasing national saving in this manner, however, would exact a toll on current consumption.